

The Impact of Raising Tax Rates on Individual Capital Gains

By

Pınar Çebi Wilber, Ph.D.

Economist

American Council for Capital Formation*

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Introduction

Chairman Camp, Senator Baucus, and members of the Committees, my name is Pınar Çebi Wilber, economist, American Council for Capital Formation (ACCF),* Washington, D.C. I am pleased to submit this testimony for the hearing record to outline some possible economic consequences of increasing long-term capital gains tax rates on individuals.

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Background

Even though the recession has been officially over since 2009, the U.S. economy continues to struggle with high unemployment and sluggish economic growth. Decision makers face major uncertainties, including the scheduled expiration of decade old tax reductions for families and individuals at all income levels, the so-called “Bush Tax Cuts.” One component of the expiring tax cuts is the individual capital gains tax rate. Without any action, the top individual capital gains tax rate will increase to 20% from the current top rate of 15%. As a result of the recently passed 2010 health care legislation, there will be an additional 3.8% tax on unearned income beginning in 2013. Coupled with the 2013 scheduled restoration of the “Pease Limitation” on

* Founded in 1973, The American Council for Capital Formation is a nonprofit, nonpartisan organization advocating sound tax, energy, environmental, regulatory and trade policies that facilitate saving and investment, economic growth and job creation. For more information about the Council or for copies of this testimony, please contact the ACCF, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006- 2302; telephone: 202.293.5811; fax: 202.785.8165; e-mail: info@accf.org; website: www.accf.org

itemized deductions (which will impose roughly a 1.2% marginal rate on capital gains), individuals will face a top federal rate on capital gains of 25%. This sharp 67% increase on investment income will no doubt have negative consequences on an already struggling U.S. economy. This testimony presents evidence on the impact of capital gains taxes on entrepreneurial activity, discusses how the U.S. tax rate compares to our trading partners and how letting the tax rate rise will impact the overall U.S. economy and job growth.

Background on Capital Gains

Over the years, the maximum tax rate on long term individual capital gains has been changed a number of times (see Chart 1). In 1986, the rate was increased to 28% from 20% (a 40% tax hike) as part of the last major tax reform in the United States. Later, the long term capital gains rate was reduced to 20% in 1997 (Taxpayer Relief Act of 1997) and to 15% in 2003 (Jobs and Growth Tax Relief Reconciliation Act of 2003). The 15% tax rate has been extended until the end of 2012 and is scheduled to revert to 20% on January 1, 2013. Including the 3.8% tax surcharge and restoration of the “Pease Limitation,” the maximum long term individual capital gains tax rate will go up to 25% if Congress does not act.

State and Federal Capital Gains Tax Rates

Unfortunately, the majority of U.S. investors not only face the Federal long term individual capital gains tax rate, but also have to factor in state level capital gains tax rates. A 2012 survey¹ conducted by Ernst & Young LLP for the ACCF Center for Policy Research (CPR) analyzed three possible scenarios:

1. 2012 law: Top effective tax rates on long-term individual capital gains under 2012 Federal and State tax laws. (Top Federal capital gains rate is 15%.)
2. 2013 law with extension of the 2001/2003 tax cuts (top Federal capital gains rate at 15%): Top effective tax rates on long-term individual capital gains in 2013, assuming an extension of the 2001/2003 tax cuts in addition to the new 3.8% Medicare tax on unearned income scheduled for 2013 for married couples filing jointly (single filers) with \$250,000 (\$200,000) or more in income. State rates that are currently scheduled for 2012 are assumed to be the same for 2013.
3. 2013 law as scheduled (top Federal capital gains rate at 20%): Top effective tax rates on long-term individual capital gains under 2013 Federal tax law (i.e., assuming the 2001/2003 tax cuts sunset on December 31, 2012 and the 3.8% Medicare tax takes effect as scheduled). State rates that are currently scheduled for 2012 are assumed to be the same for 2013. The

¹ “State and Federal Individual Capital Gains Tax Rates: How High Could They Go?,” Special Report by the ACCF Center for Policy Research, Conducted by Ernst & Young, March 2012, http://accf.org/wp-content/uploads/2012/04/ACCF_specialReport_2012_16.pdf

calculations also account for the reinstatement of the limitation of itemized deductions for high-income taxpayers (i.e., the “Pease” provision) in 2013.

Investors face State-level individual capital gains taxes in forty-one states. According to the survey, the average top individual State capital gains tax rate was 5.3% in 2012. Combined with the Federal capital gains tax rate, the average rate is 18.4%.² If Congress does not act and the capital gains tax reverts to 20%, the U.S. average tax rate will become 27.9% including the healthcare surcharge. Among the states, currently Hawaii has the highest combined State and Federal capital gains tax rate (22.2%) followed by California (21.7%). If the current capital gains tax rate expires, their rates will increase to 31.6% and 31.2% respectively (see Table 1). Given the current budget woes faced by many states, increasing the capital gains tax rate is likely to have a negative impact on budget receipts because higher tax rates make such investments less attractive and lengthen holding periods.

Why the Capital Gains Tax Rate is Important

A low capital gains tax rate has an important role to play in fostering economic growth and in promoting the entrepreneurial drive on which the U.S. economy thrives. Entrepreneurs are a major force for technological breakthroughs, new start-up companies, and the creation of high paying jobs. Combined with the State capital gains tax rates, the Federal capital gains tax rate substantially increases the difference between what an investment yields and what an individual investor actually receives (known as the “tax wedge”). The higher the tax wedge, the fewer the number of investments that will meet the “hurdle rate;” resulting in fewer investments being undertaken.

Impact on Entrepreneurs:

A recent study³ by Professor William M. Gentry conducted for the ACCF CPR, identifies mechanisms through which capital gains taxes can affect entrepreneurs’ decisions:

- Capital gains taxes may create an additional level of taxation on successful entrepreneurs.
- Asymmetric taxation of capital gains and losses (in which gains are taxed more heavily than losses) may be an especially important issue for entrepreneurs; the asymmetries in the tax system may discourage entrepreneurs from taking risk.⁴

² These calculations take into account the federal deduction for state and local income taxes paid, as well as any states that allow taxpayers to claim a deduction against their state taxes based upon their federal taxes paid.

³ “Capital Gains Taxation and Entrepreneurship,” William M. Gentry, Study Conducted for ACCF CPR, November 2010, http://accf.org/wp-content/uploads/2010/11/media_497.pdf

⁴ A Congressional Research Service report by Thomas L. Hungerford, “Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since 1945,” claims that “Consequently, a rise in the capital gains top rate could increase investment because of reduced risk.” However, the CRS study (<http://graphics8.nytimes.com/news/business/0915taxesandconomy.pdf>), seems to ignore the fact that “gains are taxed more heavily than losses” and as mentioned in Prof. Gentry’s paper cited above “Unlike a symmetric tax on returns, an asymmetric tax does not necessarily provide insurance. In the extreme, the government takes part of the

- Entrepreneurs may become locked into closely-held businesses; this lock-in effect may distort whether firms are owned by the most efficient manager for the firm.
- Capital gains taxes can affect the cost of capital for entrepreneurs

To document the potential importance of capital gains taxation on entrepreneurs, Prof. Gentry analyzes household portfolios, the composition of unrealized capital gains held by households, and whether capital gains taxes are related to disbursements by venture capital partnerships. His analysis has three main findings: First, active business assets – the types of assets that are likely to be associated with capital gains for entrepreneurs – play an important role in the aggregate portfolio of household assets. According to the 2007 Survey of Consumer Finances (SCF), 11.1 percent of households hold active business assets, and these assets account for 19 percent of household portfolios; by comparison, stocks held directly or in mutual funds (but outside of retirement accounts) are 11.7 percent of household wealth.

Second, the stock of unrealized capital gains associated with privately held businesses is large. The SCF data suggest that aggregate unrealized capital gains on active business assets are almost six times larger than aggregate unrealized capital gains on corporate stock. The magnitude of unrealized capital gains on active business assets suggests that the capital gains tax rate could play an important role in whether and when these assets are sold. In fact, as shown in Chart 1, long term capital gains realizations in the economy plotted against historical capital gains tax rates seems to support this belief. In fact, a new analysis by the Congressional Budget Office⁵ measures how changes in the capital gains tax rate affects the decision to realize gains (called the “elasticity” of response to a change in the tax rate). According to their estimates, the persistent⁶ elasticity is estimated to be -0.79, while the transitory elasticity is estimated as -1.2, suggesting that capital gains realizations are quite responsive to tax rates. Understanding the elasticity of response by taxpayers to changes in tax rates helps policymakers understand the impact that changes in capital gains tax rates will have on investors, on the formation of new ventures and on both state and federal budget receipts.

Third, Prof. Gentry examines whether capital gains tax rates affect the disbursements of venture capital funds using state-aggregate data from 1969-2007. Regression analysis suggests that higher capital gains tax rates are associated with a reduction in state-level disbursements from venture capital funds. Since many of the sources of venture capital funding are not subject to capital gains taxation, Prof. Gentry interprets this finding as

upside of the venture but does not share in its losses.” (pg 22). See Gentry paper cited above, especially pages 22-25 for a discussion of the asymmetric treatment of capital gains and losses.

⁵ “New Evidence on the Tax Elasticity of Capital Gains,” A Joint Working Paper of the Staff of the Joint Committee on Taxation and The Congressional Budget Office, June 2012, <http://www.cbo.gov/publication/43334>

⁶ Authors describe “persistent” as “the effect of an increase in tax rate that has persisted over the previous year and is also expected to persist into the next year” (pg 4)

suggestive of a demand side effect: in states with higher capital gains tax rates, fewer entrepreneurs are starting businesses that seek venture capital funding.

Impact on the Overall Economy:

In order to analyze the impact of alternative capital gains tax rates on the economy, Dr. Allen Sinai, president and CEO of Decision Economics, Inc., simulated various rates, high and low, using the large scale Sinai-Boston macroeconometric model of the U.S. economy. The study⁷ was conducted in 2010 for ACCF. The results include:

- Raising the capital gains tax rate from the current 15% to 20%, 28% or 50%, reduces growth in real GDP, lowers employment and productivity and, after feedback effects, increases the federal budget deficit. For example, at a 20% capital gains rate, real economic growth falls by 0.05 percentage points per year and jobs decline by 231,000 a year, compared to the base case, which uses the 15% capital gains tax rate (see Table 2). When the rate is increased to 28%, real GDP growth declines by 0.1 percentage points per year and there are 602,000 fewer jobs created each year.⁸
- Reducing the capital gains tax rate to zero increases growth in real GDP by a little over 0.23 percentage points per year and there is an average of 1,323,000 more jobs created annually. The unemployment rate drops by an average of 0.5 percent, and productivity growth improves by 0.5 percentage points a year.
- Reducing capital gains taxes also causes realizations to rise as investors and businesspersons cash-in long-term capital gains. Consumer spending increases as capital gains realizations, aftertax, are “spent” or “saved.” The rise in asset prices, both in the values of equity and residential real estate, is reflected in a stronger household balance sheet and reductions in debt because of increased income and capital gains realizations. Household financial conditions improve; in turn, reducing the risk of lending to households and increasing the availability of credit.
- Lower and higher capital gains tax rates also affect the financial positions of household and corporations. When capital gains taxes are reduced, the after-tax return on equity rises, stock prices increase, household wealth is higher, some capital gains are realized, consumption increases, output and production rise, capital spending increases, household financial assets tend to rise, liabilities decline, debt service burdens are reduced, and household financial conditions improve (see Table 2). These financial effects support

⁷ “Capital Gains Taxes and the Economy,” Allen Sinai, Prepared for the ACCF CPR, September 2010. http://accf.org/wp-content/uploads/2010/09/media_487.pdf

⁸ Contrary to a recent Congressional Research Service analysis “Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since 1945,” <http://graphics8.nytimes.com/news/business/0915taxesandconomy.pdf> which claims “The reduction in the top tax rates appear to have little or no relation to the size of the economic pie,” Dr. Allen Sinai’s research suggests otherwise. Dr. Sinai’s detailed macroeconomic model captures how the taxation of capital gains reverberates through the economy and impacts investment, employment, GDP and other key variables.

additional spending out of disposable income and tend to sustain and raise for a longer time the multiplier effects from the reduction in capital gains tax.

A more recent Allen Sinai study⁹, confirms the results of previous study. The new study, using current data on U.S. economy analyzes the impact of increasing capital gains tax rate to 20% from 15% in combination with an increase in the dividend tax rate to 39.6% from the current 15%. Dividends, similar to capital gains, are subject to double taxation and taxing the dividend income has negative impact on financial markets. The combined increases in these two tax rates amplify the negative macroeconomic impact on the U.S. economy. Some results of the study are (see Table 3):

- Real GDP growth decreases 0.1%, on average, per year, which equates to a \$79.2 billion decrease per year over the 2013-17 time period. The results are similar in longer time period: Between 2013 and 2021 period, real GDP decreases \$80 billion on average, per year.
- Consumption spending is also weaker, averaging \$155 billion lower per year between 2013 and 2021 (see Table 3). Between 2013 and 2017 time period, the decrease in consumption is a little over \$122 billion.
- The job impact is worse between 2013 and 2017. The economy ends up losing 380,000 jobs on average per year. In the longer period, 2013-21, the loss is 344,000 per year. Nonfarm payroll jobs show a large loss of 561,000 persons in 2015 and then smaller losses in subsequent years.
- Spending for business investment declines when tax rates on capital gains and dividends revert to pre-Bush levels; on average \$20 billion yearly between 2013 and 2021 (see Table 2). The decrease is smaller for the shorter term, 2013-17, \$17.9 which is 1.1% lower than baseline.
- Both the S&P 500 Price Index and S&P 500 Earning per Share decline when the top tax rates on qualifying dividends and capital gains are increased compared to the Baseline. The index declines by an average of 16% and the S&P 500 Operating EPS is down an average of \$1.6 over 2013-17. Between 2013 and 2021, the index declines by an average of 14.5% and the S&P 500 Operating EPS is down an average of \$2.
- Higher taxes on capital gains and dividends significantly harm the economy and job growth and suggest that the increase in federal tax receipts may not be a worthwhile tradeoff. Despite all that damage to the economy, the overall impact on the budget deficit is only \$7.3 billion annually (see Table 3) between 2013-2017 and \$70.4 billion between 2013-2021 when the dynamic effects on economic activity and induced decreases in tax receipts from the higher tax rates are reflected.

⁹ “The Fiscal Cliff: Impact on U.S. Economy and Employment if Bush Tax Cuts Expire,” Allen Sinai, Report Prepared for ACCF CPR, June 2012. <http://accf.org/uncategorized/macro-economic-effects-of-coming-tax-increases-2013-22>

Impact on International Competitiveness:

A new report¹⁰ by Ernst & Young LLP compares individual long-term capital gains taxes among major economies of the world as well as major trading partners of the U.S. The U.S. capital gains tax rate compares unfavorably with that of many other major economies (see Chart 2).

The tax increase in the 2010 health-care reform will bring the long-term U.S. capital-gains rate in 2013 to 18.8 percent. If the Bush tax cuts expire, as they are set to do in 2013, the rate will hit almost 24 percent combined with health-care surcharge. In his State of the Union address, President Obama suggested a minimum 30% tax rate on people making more than \$1 million, which would make U.S. rate fifth highest after Italy, Denmark, France and Sweden. Extension of the 15% rate is crucial to maintaining the U.S. competitive edge against its major trading partners.

Conclusions

Dynamic macroeconomic analyses show that raising capital gains taxes will slow overall economic and job growth. In addition, government tax receipts (U.S. and states) are likely to decline and entrepreneurial activity in the U.S. may be discouraged. Finally, our international competitiveness will be negatively impacted if the individual capital gains rate increases since our rate will be among the highest in the industrial world, thus making the U.S. a less attractive place to invest. When thinking about tax reform, policymakers should consider the negative consequences of taxing investment income. There need not be a binary choice between lower individual income tax rates and keeping tax rates on investment income at current levels.

¹⁰ "Corporate Dividend and Capital Gains Taxation: A Comparison of the U.S. to Other Developed Nations," Prepared for the Alliance for Savings and Investment, Ernst & Young, http://www.theasi.org/assets/EY_ASI_Dividend_and_Capital_Gains_International_Comparison_Report_2012-02-03.pdf

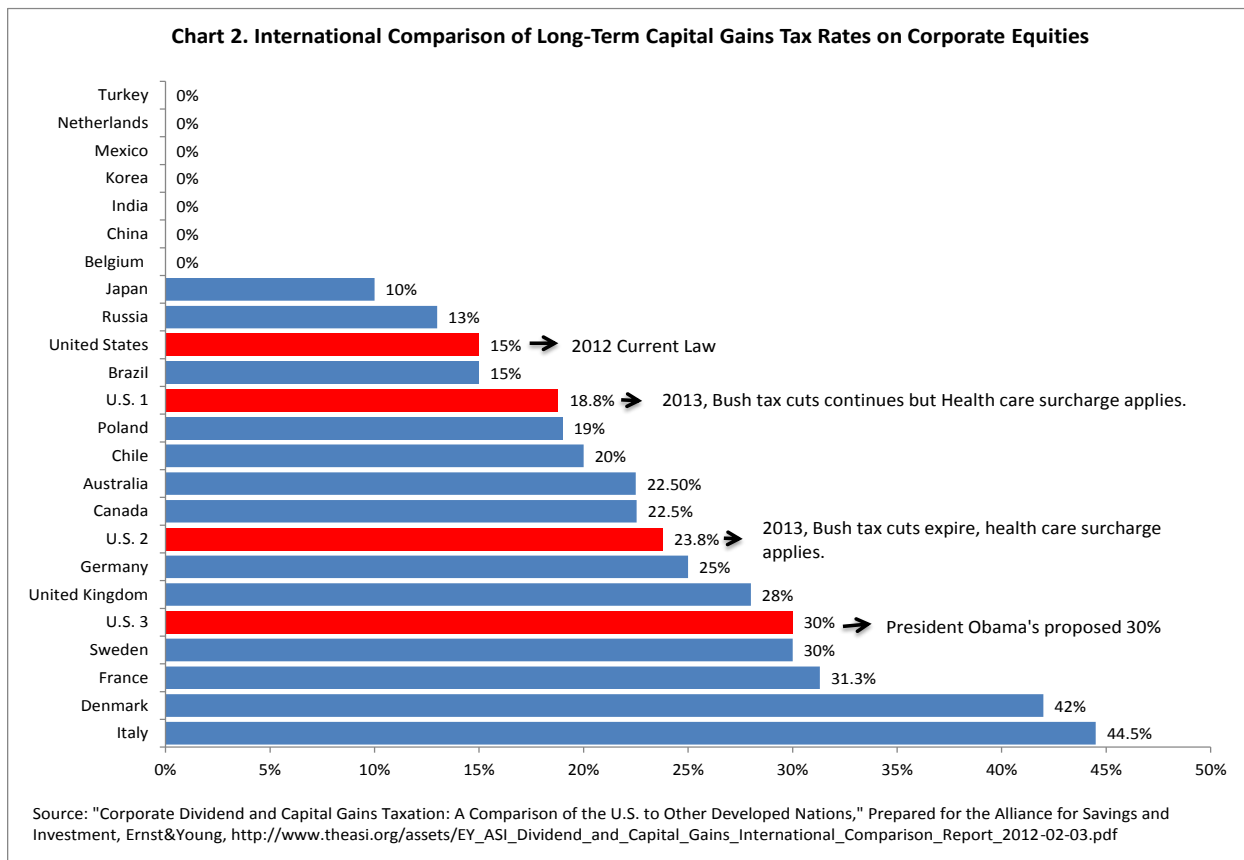
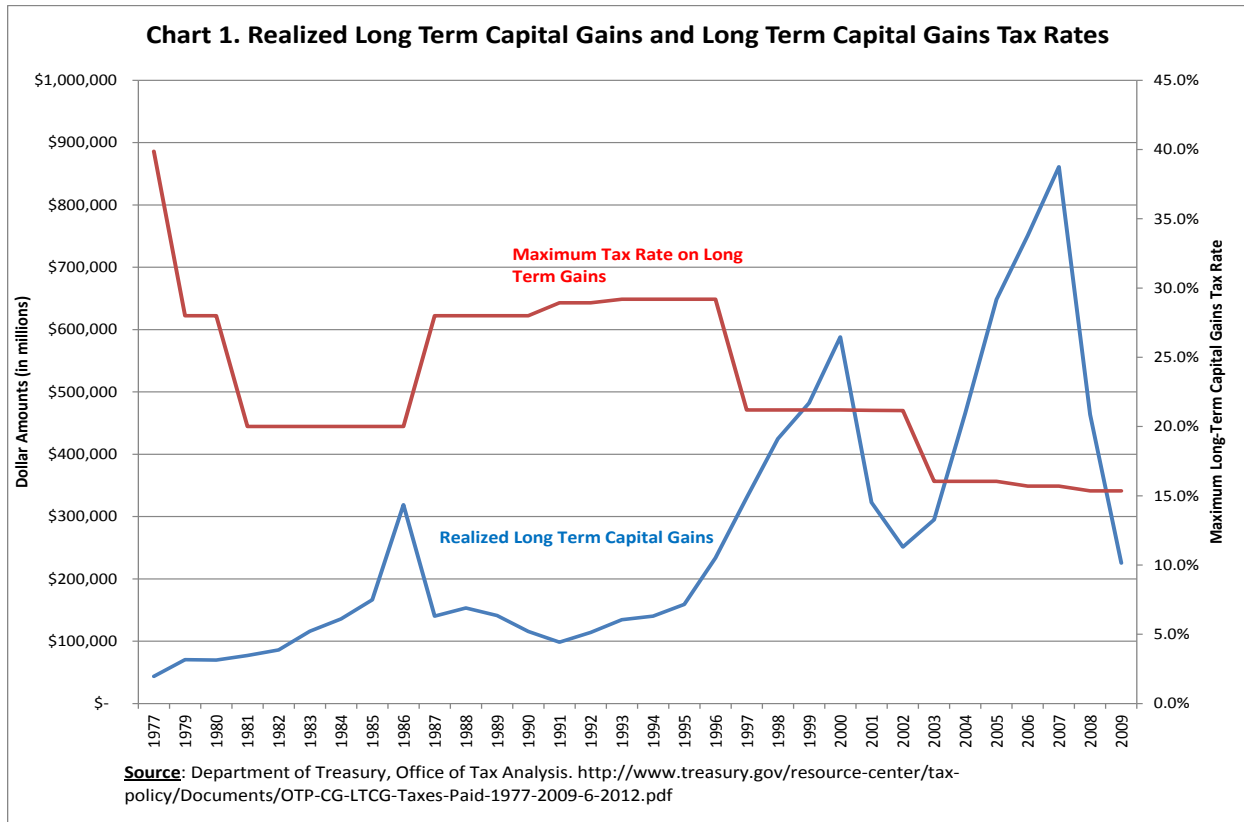


Table 1. Sample of States with Highest Rates for Combined State and Federal Individual Capital Gains Taxes

	Top effective long-term state tax rate	Including top federal marginal tax rate		
		2012 law	2013 law w/ extension of 2001/2003 tax cuts	2013 law as scheduled (tax cuts expire)
Hawaii	11.00%	22.2%	26.0%	31.6%
California	10.30%	21.7%	25.5%	31.2%
Oregon	9.90%	21.4%	25.2%	31.0%
Vermont	8.95%	20.8%	24.6%	30.4%
Washington, DC	8.95%	20.8%	24.6%	30.4%
New Jersey	8.97%	20.8%	24.6%	30.4%
New York	8.82%	20.7%	24.5%	30.3%
Maine	8.50%	20.5%	24.3%	30.1%
Minnesota	7.85%	20.1%	23.9%	29.7%
Iowa	8.98%	20.1%	23.9%	29.4%
U.S. Average	5.30%	18.4%	22.2%	27.9%

Source: “State and Federal Individual Capital Gains Tax Rates: How High Could They Go?,” Special Report by the ACCF Center for Policy Research, Conducted by Ernst & Young, March 2012, http://accf.org/wp-content/uploads/2012/04/ACCF_specialReport_2012_16.pdf

Table 2: Macroeconomic Effects of Changes in the Capital Gains Tax Rate (Diffs. from Baseline, Avg. Per Year, 2011-16)*

Variables	Raised to 50 Pct.	Raised to 28 Pct.	Raised to 20 Pct.	Lowered to 10 Pct.	Lowered to 5 Pct.	Lowered to 0 Pct.
Real GDP Growth (Pctg. Pts.)	-0.3	-0.1	-0.05	0.10	0.16	0.23
Inflation (Pctg. Pts.)						
GDP Chain Price	-0.36	-0.13	-0.04	0.08	0.15	0.30
CPI-U	-0.72	-0.26	-0.09	0.16	0.29	0.61
PCE Chain Price	-0.33	-0.12	-0.04	0.07	0.13	0.26
Unemployment Rate (Pct.)	0.4	0.2	0.1	-0.1	-0.2	-0.5
Nonfarm Payrolls (Mils. Jobs)	-1.628	-0.602	-0.231	0.381	0.711	1.323
Productivity Growth (Pctg. Pts.)	-0.6	-0.2	-0.1	0.1	0.3	0.5
Federal Budget Deficit, Unified	-401.8	-174.5	-8.0	-33.5	-118.2	-143.4
Avg. per Year (Bils. \$s)	-67.0	-9.8	-1.3	-5.6	-19.7	-23.9
Budget Chg., % of Baseline GDP	-2.4	-1.0	-0.0	-0.2	-0.7	-0.8
Receipts, Unified (Bils. \$s)	-49.6	-6.2	-1.0	-7.7	-21.6	-32.8
Ex-Ante Cost (Static) (Bils. \$s)	1148.9	551.6	272.0	-268.9	-435.6	-451.5
(Avg. per Year)	191.5	91.9	45.3	-44.8	-72.6	-75.2
% of GDP	1.1	0.5	0.3	-0.3	-0.4	-0.4
Ex-Post Cost (Dynamic) (Bils. \$s)	-401.8	-37.2	-6.2	-46.4	-129.6	-196.7
(Avg. per Year)	-67.0	-6.2	-1.0	-7.7	-21.6	-32.8
% of GDP	-2.4	-0.2	0.0	0.0	-0.1	-0.2

*Simulations using the Sinai-Boston (SB) Model of the U.S. Economy. Monetary policy unchanged

Source: “Capital Gains Taxes and the Economy,” Allen Sinai, Prepared for the ACCF CPR, September 2010. http://accf.org/wp-content/uploads/2010/09/media_487.pdf